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Private Bank Lending and Developing-Country Debt

Private Bank Lending and Developing-Country Debt

PIERRE SAUVÉ

The Institute for Research on Public Policy/

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Foreword

No international economic issue has attracted as much attention in recent years — and with reason — as the international debt issue. The near-collapse of the international financial system in 1982 prompted even those with little previous interest in the subject to follow the issue closely. This crisis also helped to establish the reality of North-South interdependence in the minds of the general public.

In this first publication on a financial subject of The Institute's *Essays in International Economics* series, Pierre Sauvé examines several important aspects of the international debt issue. He reviews the reasons behind the external debt crisis that emerged at the beginning of the decade, as well as the major changes in the sources of balance-of-payments financing. He analyses the weaknesses in the design and function of the international framework for both financing and adjustment, and discusses and evaluates several reform proposals. A failure to deal effectively with present shortcomings in recycling arrangements, Mr. Sauvé concludes, is likely to create conditions whereby illiquidity may transfer itself into global insolvency.

Mr. Sauvé, currently a Ph.D. candidate at Oxford, has drawn on the work he has done previously at the Université de Montréal, the Norman Paterson School of International Affairs at Carleton University, Ottawa, Cambridge University, and as a summer intern at the International Monetary Fund.

Gordon Robertson
Past President and Fellow-in-Residence

July 1984

Avant-propos

Ces dernières années, aucune question économique internationale n'a autant retenu l'attention, et ce avec raison, que celle de l'endettement mondial.

En 1982, lorsque le régime financier international a failli s'écrouler, même ceux qui jusqu'alors ne s'intéressaient que de loin à ce sujet se sont mis à suivre la question de plus près. Cette crise a, d'autre part, aidé à concrétiser l'interdépendance Nord-Sud dans l'esprit du grand public.

Dans ce premier ouvrage des *Essais sur l'économie internationale* de l'Institut consacré à une question financière, M. Pierre Sauvé se penche sur plusieurs aspects importants du problème de l'endettement international. Il évalue les raisons de la crise de la dette exterieure survenue au début de la décennie ainsi que l'évolution des principales sources du financement de la balance des paiements. Il analyse les faiblesses des structures et du fonctionnement du régime international tant pour le financement que l'ajustement, en plus d'étudier et d'estimer plusieurs projets de réforme. L'auteur conclut que si on ne réussit pas à combler efficacement les lacunes actuelles dans les dispositions de recyclage, on risque de créer des conditions susceptibles de transformer le manque de disponibilités en insolvabilité mondiale.

M. Sauvé, actuellement candidat au doctorat à l'université d'Oxford, s'est inspiré de ses travaux antérieurs effectués à l'université de

Montréal, à la *Norman Paterson School of International Affairs* de l'université Carleton, (Ottawa), à l'université Cambridge ainsi que lors d'un stage d'été au Fonds monétaire international.

Gordon Robertson
Ancien président

Juillet 1984

The Author

Pierre Sauvé is a doctoral candidate in economics at the University of Oxford, where he is engaged in research on the macro-economic effects of balance-of-payments adjustment policies in developing countries. He has already obtained a B.Sc. in economics from the Université du Québec à Montréal, an M.A. from the Norman Paterson School of International Affairs, Carleton University, and an M.Phil. in development economics from the University of Cambridge. The present study was completed while the author was an intern at the International Monetary Fund during the summer of 1983.

Summary

Of the numerous problems which have beset the international economy in recent years, few have figured as prominently as that of the Third World's external indebtedness. The total outstanding debt of the non-oil developing countries has risen from United States (US) $86 billion in 1971 to US $606 billion at the end of 1983. If short-term debt is included, the aggregate figure surpasses the $800-billion mark. The debt problem simultaneously represents a major threat to the stability of the world financial system, to recovery from the recession of the early 1980s, and to the economic prospects of the numerous debtor countries.

Rising levels of indebtedness have always been closely related to the process of economic growth in both developed- and developing-country settings. Nevertheless, given the amounts and bank exposures involved, drastically altered conditions prevailing in the international economy have invalidated the assumptions upon which the growth-cum-debt strategies of many borrowing countries had been predicated. Moreover, the severity of the Third World's actual debt burdens is such that the problems posed by that debt's resolution can no longer be couched in either temporary or technical terms, but rather embody the very characteristics of the much wider crisis which permeates the present framework for development financing.

The external-debt crisis that emerged in many developing countries from 1981 onward occurred as a result of the convergence of several factors: successive oil shocks in 1973-74 and 1979-80; high real interest rates since 1980; declining export prices and volumes

associated with the world recession of 1981-83; the marked deceleration of net private bank lending since 1982; and steep rises in the US dollar's exchange rate since 1981. Globally, therefore, it can be argued that the debt problem of the less-developed countries (LDCs) owes much of its acuteness to two main contributing factors:

- Policy reactions to oil shortage and inflationary pressures by Western governments
- Structural weaknesses in the overall framework for financing and adjusting to new patterns of global payments imbalances.

The deflationary policies pursued by the industrialized countries in response to the second oil shock have dramatically altered the conditions within which the growth of private bank lending had taken place. Under the dead weight of stagnating world trade and unmanageable debt-servicing profiles, the international financial system has shown signs of worrisome vulnerability. Engineering the transition from inflation to disinflation in the world economy through the application of severe monetary restraint has thus proved a risky experiment, especially in view of the toll it has already exacted on world levels of output and unemployment.

As deflationary policies have been applied against the backdrop of major changes in the sources of balance-of-payments financing (the so-called 'privatization' of the recycling mechanism), important weaknesses in both the design and the functioning of the international framework for financing and adjustment have become conspicuous. Thus, by being primarily a function of the credit rating of the commercial banking sector, because of the growing paucity of official sector financing, the present framework provides financing to only a handful of deficit countries which, under current conditions, have run into a crisis of debt servicing. Secondly, this framework places the bulk of adjustment pressures on countries whose capacity to adjust is the weakest. The net result is a process of income adjustment in debtor countries which has a cumulatively deflationary effect on the world economy.

Considering the extent of external financing requirements to be faced by LDCs in the medium term, the general outlook for LDC debt servicing, as well as the constraints likely to be felt by private banks in meeting these requirements on the same scale as in the past, a satisfactory outcome to the Third World's external indebtedness problem is unlikely to evolve if resource flows are to be left to the private sector. It is quite clear, indeed, that because of the skewedness and procyclical tendencies of present-day recycling arrangements, these arrangements simply do not offer a viable lending

policy for the long run, and this situation, in an international economy in which countries are financially interdependent, could dampen recovery prospects for the industrial country.

As needs for net capital inflows, that is, for incurring debt, remain very high in less-developed countries, ways must be found to channel funds that are more consistent with the overall debt-servicing capacity of developing countries, given the harsher world economic environment of the 1980s; these ways must also be more consistent with the need of LDCs to undertake longer-term structural adjustment in such an environment. A package of reforms in the areas of recycling and development finance must therefore revolve around three broad principles:

- Continued intermediation in financial markets to prevent drastic declines in net bank lending to deficit countries and prohibitive declines in world income
- The restoration of a better balance between private and public sources in the recycling process. This new balance will reduce the exposure of private sources, while strengthening the influence of public sources, particulary with regard to the needs of low-income countries.
- The adoption of more expansionary policies relating to industrial countries, which will permit an expansion in LDC exports. This development will be conducive to resuming sustainable debt servicing.

Failure to orchestrate reforms along these lines is likely to create conditions whereby the LDC-debt problem might suddenly transform itself from one of systemic illiquidity to one of widespread insolvency. It remains to be seen, however, whether all actors involved will admit their responsibilities in contributing to a more stable world economy. The stage is certainly set.

Abrégé

Parmi les nombreux problèmes qui ont assailli l'économie internationale ces dernières années, l'endettement extérieur du Tiers monde est certes l'un de ceux qui a attiré le plus d'attention. Le total des créances à recouvrer des pays en voie de développement, non producteurs de pétrole, est passé de 75 milliards de dollars USA en 1971, à 520 milliards de dollars US à la fin de 1982. Si l'on tient compte de la dette à court terme, le montant total dépasse les 700 milliards de dollars. Le problème d'endettement représente à la fois une menace importante à la stabilité du régime financier international, à la reprise qui s'est amorcée après la recession du début des années 1980, ainsi qu'aux perspectives économiques des nombreux pays débiteurs.

Le processus de la croissance économique a toujours été étroitement lié à l'augmentation du niveau d'endettement, tant dans les pays développés que dans les pays en voie de développement. Il reste cependant que, compte tenu du degré de vulnérabilité des banques et des sommes en cause, le bouleversement des conditions prédominantes dans l'économie internationale a largement modifié les hypothèses sur lesquelles s'appuyaient les stratégies de croissance-endettement de plusieurs pays emprunteurs. En outre, l'ampleur de la dette réelle du Tiers monde est telle qu'il est devenu impossible de formuler des solutions en termes temporaires ou techniques. Cette dette n'est qu'une des manifestations de la crise beaucoup plus vaste que connait l'ensemble des structures de financement du développement.

Depuis 1981, c'est la convergence de plusieurs facteurs qui a déclenché la crise de la dette extérieure pour de nombreux pays en voie de développement: les chocs pétroliers qui se sont succédés en 1973-1974 et 1979-1980, l'ampleur des taux d'intérêts réels en 1980–1982, le déclin des prix et du volume des exportations provoqués par la récession mondiale de 1981-1982 et le ralentissement notable du crédit net consenti par les banques privées en 1982-1983. On peut donc soutenir qu'à l'échelle mondiale, deux facteurs principaux sont avant tout responsables de la gravité du problème d'endettement des pays moins développés (PMD):

- les mesures prises par les gouvernements occidentaux en réaction aux pénuries de pétrole et aux pressions inflationnistes
- la faiblesse structurelle de l'ensemble du système servant à financer et à s'adapter aux nouveaux profils de déséquilibre des paiements à l'échelle mondiale.

Les mesures déflationnistes adoptées par les pays industrialisés en réaction au deuxième choc pétrolier ont modifié radicalement les conditions qui présidaient à la croissance du crédit consenti par les banques privées. Malgré le boulet d'un commerce mondial en stagnation et d'intraitables profils du service de la dette, le régime financier international a manifesté des signes inquiétants de vulnérabilité. Il s'est donc avéré très risqué d'opérer le passage de l'inflation à la désinflation de l'économie mondiale par l'application de restrictions monétaires rigoureuses, compte tenu surtout du prix déjà payé en termes de niveaux de production et de chômage dans le monde.

Avec l'application de mesures déflationnistes dans le contexte d'une évolution profonde des sources de financement de la balance des paiements (connu sous l'appellation de « privatisation » du mécanisme de recyclage), d'importantes faiblesses structurelles et fonctionnelles du régime international de financement et d'ajustement sont devenues évidentes. Ainsi, du fait qu'il est avant tout fonction de la cote de solvabilité du secteur bancaire commercial et, en raison du resserrement croissant du financement par le secteur officiel, le cadre actuel ne permet le financement que d'une poignée de pays en déficit qui, actuellement, sont aux prises avec une crise du service de la dette. En deuxième lieu, un tel système fait porter le gros des pressions d'ajustement aux pays qui, précisément, sont le moins aptes à le faire. Il en résulte donc un mécanisme d'ajustement du revenu, dans les pays débiteurs, qui exerce un effet déflationniste cumulatif sur l'économie mondiale.

Compte tenu de l'ampleur des besoins de financement extérieur auxquels devront faire face à moyen terme, les PMD, des perspectives générales du service de la dette des PMD, ainsi que des contraintes auxquelles seront probablement soumises les banques privées en tentant de satisfaire ces exigences dans la même mesure que par le passé, on risque peu de résoudre le problème d'endettement extérieur du Tiers monde d'une façon satisfaisante en se fiant au secteur privé pour les entrées de fonds. Cependant, il est bien évident que les dispositions de recyclage, en raison de leur asymétrie et de leurs tendances procycliques, ne favorisent tout simplement pas la viabilité à long terme des mécanismes de crédit. Une telle situation, dans le cadre d'une économie internationale d'interdépendance financière, pourrait assombrir les perspectives de relance des pays industriels.

Comme les besoins d'influx nets de capitaux, c'est-à-dire d'endettement, demeurent très élevés dans les pays moins développés, il faut trouver des moyens de leur acheminer des fonds qui soient plus compatibles avec la capacité globale du service de la dette des pays en voie de développement dans l'environnement économique plus aride des années 1980. Ces moyens devront aussi mieux tenir compte du besoin des PMD d'opérer un ajustement structurel à plus long terme dans un tel environnement. Trois grands principes doivent présider aux réformes du recyclage et du financement du développement:

- une intermédiation permanente sur les marchés financiers en vue de prévenir un déclin dramatique du crédit bancaire net proposé aux pays en déficit et une chute excessive du revenu mondial;
- le rétablissement d'un meilleur équilibre entre les sources privées et publiques de recyclage pour réduire la vulnérabilité des sources privées tout en raffermissant l'influence des sources publiques, particulièrement à l'égard des besoins des pays à faible revenu;
- l'adoption de politiques plus expansionnistes dans les pays industriels en vue de permettre une expansion des exportations des PMD. Cela favoriserait le retour à un service de la dette viable.

Si on n'orchestre pas de réformes en ce sens, on risque de créer des conditions en vertu desquelles le manque omniprésent de disponsibilités des PMD pourrait se transformer en insolvabilité globale. Cependant il reste à voir si tous les intervenants reconnaîtront leur responsabilité dans la stabilisation de l'économie mondiale. La situation est certes bien arrêtée.

1: *Debt Privatization in Less-Developed Countries*

Introduction

Of the numerous problems which have lately beset the international economy, few have figured as prominently as that of the Third World's external indebtedness The total outstanding debt of the non-oil developing countries has risen from $86 billion in United States (US) funds in 1971 to $606 billion at the end of 1982. (See Table 1-1) If short-term debt is included, the aggregate figure surpasses the $800-billion mark. Debt is nothing new to developing countries. In fact, one might say that debt, when viewed in historical perspective, is a natural concomitant of the growth process, be it in developed or developing areas. Nevertheless, in recent years, worsening economic trends have dramatically altered the environment within which the growth of sovereign debt took place.

A decade of reinforcing trends in the world economy has contributed to making Third World debt a problem. Among the most conspicuous aspects of this problem, perhaps, are growing privatization of the recycling mechanism;[1] the increase in the demand for loans by less-developed countries (LDCs), which has occurred in response to successive relative price shocks; and the restrictive anti-inflationary policies adopted by the governments of industrial countries.

By examining more closely the interplay of such trends, we seek to shed some light on the evolution of the recycling process in the post-1973 period. In doing so, we will place particular emphasis on

locating the sources of the actual crisis in Third World debt, and on showing how the debt problem itself is better understood in the context of the wider problem that exists throughout the present framework of development financing.

Briefly stated, the essay will focus upon four specific issues. First, it will relate the origins of the privatization of the Third World's external indebtedness to developments in the international economy during the last decade and show how banks have come to play a dominant role in balance-of-payments financing. Secondly, it will draw attention to the changing perceptions of the adequacy of actual recycling mechanisms from that of general disregard (following the first oil shock) to one of widespread concern (in the aftermath of the second oil shock), and will identify what appear to be the root causes of the actual crisis in development finance. Thirdly, it will assess the developmental impact of the privatization of resource flows to less-developed countries. Finally, it will examine some proposals for reform in the areas of recycling and development finance.

The main conclusion which the analysis suggests is that without major institutional change, present-day recycling arrangements are unlikely to provide LDCs with the financial resources required to face the harsh realities of adjustment in the medium term, which, in an international economy linked by financial interdependence, could hamper prospects for the recovery of industrial countries.

Note

1. A phenomenon which is mirrored by the inadequacies of official financing mechanisms.

Table 1-1: *Total Disbursed Long-Term Debt of Developing Countries at Year-End, 1971-83, by Source and Terms of Lending*[a] *(U.S. $ billion)*

Source and terms of lending	*1971*	*1975*	*1976*	*1977*	*1978*	*1979*	*1980*	*1981*	*1982*	*1983*
1. DAC Countries and capital markets	68	131	160	200	255	301	342	381	414	455
ODA	24	34	36	41	49	53	57	57	59	61
Total export credits	26	40	49	64	82	98	110	117	121	127
Total private	18	57	74	95	124	151	175	207	234	267
of which: bank loans[b]	10	46	59	75	98	123	145	175	200	234
bonds	4	5	6	9	13	13	15	16	16	15
other	3	6	9	11	13	14	15	17	18	18
2. Multilateral	9	21	26	32	39	46	55	64	75	84
of which: concessional	6	10	12	14	17	20	24	27	30	33
3. CMEA countries	6	9	9	11	12	15	15	16	17	18
of which: concessional	5	8	8	9	10	11	12	13	13	14
4. OPEC Countries	x	6	8	11	13	15	18	20	21	23
of which: concessional	x	5	6	8	9	11	12	14	15	16
5. Other LDCS	2	3	3	4	5	6	7	7	7	8
of which: concessional	1	2	2	2	3	3	3	3	3	3
6. Other and adjustments	1	3	5	5	7	8	8	13	18	18
Total Debt	86	173	211	262	331	391	445	501	552	606
of which: concessional	33	59	65	76	89	99	109	114	121	130
non-concessional	53	114	146	186	243	292	336	387	431	476

Notes

a. Source: Organisation for Economic Co-operation and Development (OECD), *External Debt of Developing Countries: 1983 Survey*, p. 54.

b. Such figures exclude short-term debts, which at year-end 1983 amounted to U.S. $126 billion according to latest International Monetary Fund (IMF) estimates.

c. Bank loans other than export credits.

2: *The Origins of LDC Debt Privatization*

Much has been said of the perils to developing countries — and to the international banking system — from the rapid buildup of their external indebtedness during the 1970s and early 1980s. Indeed, the growing debt problems of the less-developed countries (LDCs), in the context of other signs of economic deterioration, have created widespread concern within the international community over the possibility of a world-wide financial crisis. Such a crisis can be defined as the point where the liquidity squeeze on banks itself becomes a force in the recession, which is transmitted to the productive economy. Worrisome developments of this kind thus beg an important question: How is it that over the past decade, private banks have come to play such a crucial role in the transfer of financial resources to the developing world?

In much the same way that the Third World-debt problem emerged from a whole set of factors, so, too, an interaction of forces, affecting both the supply of and the demand for resource transfers to the developing world, impelled private banks to finance on an unprecedented scale the developing countries' growing financial needs.[1] The answer to the question posed above, however, appears to be essentially threefold:

- A greater involvement of commercial banks in Third World debt has been and continues to be, to a large degree, the result of the inadequacy of alternative flows.

- Such involvement, moreover, arises from the dramatic demand for short- and medium-term balance-of-payments financing in the post-1973 period.
- The supply of financing has been determined predominently by developments and change within the Euro-currency markets themselves.

There was a time, indeed, when official agencies would have been expected to act as the principal intermediaries between surplus and deficit countries. When the need for external financing arose in the early 1970s, however, private international financial markets had already developed to the point at which they were able to perform this function efficiently. The growing importance of private bank recycling can thus be partly explained by the fact that the financial capacity of the traditional, international, financial agencies was both quantitatively and qualitatively insufficient to meet the borrowing requirements of the developing world.

The financial flows stemming from the multilateral financial institutions such as the International Monetary Fund (IMF), the International Bank for Reconstruction and Development (World Bank), and the regional development banks have long been inadequate to meet the external capital requirements of the developing countries. Moreover, although significant new sources of financing were created (for example, the IMF Oil Facility of 1974-75, the Extended Fund Facility, the World Bank's Structural Adjustment Lending program, co-financing), these sources were nowhere near adequate to deal with the much larger current account/balance-of-payments deficits of the non-oil developing countries in the post-1973 period. It has been estimated that the IMF and other multilateral lending institutions contributed only 3.1 per cent of the cumulative finance needed by LDCs between 1973 and 1980, "and this at a time when the LDCs as a whole were in severe financial difficulties and the Fund's contribution might have been expected to be greatest."[2] The growth of private bank lending to LDCs also coincided with the marked stagnation of official sources of development assistance. Official development assistance (ODA) flows, as a percentage of grantors' gross national product (GNP), did not improve throughout the 1970s; in fact, at the end of 1983, it stagnated at about 0.36 per cent for countries which were members of the Development Assistance Committee (DAC) of the Organisation for Economic Co-operation and Development (OECD). Even more telling is the fact that expressed as a percentage of the current account deficit of the non-oil-producing LDCs, aid levels were more than halved from 1973 to 1983.

The extent of private sector involvement in the provision of financial resources to LDCs during the 1970s has, in contrast, been quite impressive. (See Table 2-1.) Private sources accounted for 53.6 per cent of net flows of medium- and long-term capital in 1970, 65.1 per cent in 1973, and 72.0 per cent in 1980.[3] By 1980 private debt accounted for over 65 per cent of outstanding (medium- and long-term) debt, compared with 45 per cent ten years earlier. Debt owed to private banks as a percentage of total outstanding debt reached 45 per cent in 1982, compared with slightly more than 10 per cent in 1970.[4]

Over the last decade, the increased availability of loans from private banks was facilitated by a set of institutional developments in international financial markets, which permitted a growing pool of short-term funds to be transformed into medium-term and longer-term loans without the previous risks. These developments include the phenomenal growth in the number of banks active in the Euro-markets and involved in the recycling process, as well as the degree of competitiveness which followed this growth. Moreover, innovations in the banking process, such as the advent of syndication and consortium banking, floating interest rates, and roll-over credits, further reduced the risks of lending to the generally less-creditworthy peripheral countries.[5]

In the 1970s one of the main determinants of the volume of net capital flows available for recycling was the size and distribution of world-wide current account surpluses and deficits. The larger the absolute size of ex post surpluses, the larger the volume of flows that were processed through the international commercial banking sector. In this respect, private banks assumed the crucial role of responding to the massive short-term demand for balance-of-payments financing that emerged as a result of the fourfold increase in the price of oil in October 1973. They did so by providing members of the Organization of Petroleum Exporting Countries (OPEC) with substantial investment opportunities, thereby permitting the international economy to avoid the severely deflationary bias posed by OPEC's absorption-capacity problem. Overall, it can be said that commercial banks were generally well positioned, in the 1970s, to profit from the severe dislocations that characterized the international economy. Since private bank finance provided much greater speed and flexibility than bilateral or multilateral financing arrangements tended to permit, and since its forms of conditionality were less overt, it came to be seen, in both Northern and Southern circles, as quite responsive to the requirements of countries pursuing long-term development strategies in fast-changing economic environments.[6]

Table 2-1: *Total Debt Disbursed at Year End, 1971-82 and Debt Service in 1982[a] (by terms of lending and income group)*

Income Group	*Total debt ($ bil.)*	*Percentage share of total*			
		ODA	*Non-conces. multil.[b]*	*Export credits*	*Private market*
Low-income LDCs					
1971	18.0	73	6	19	2
1975	40.0	73	4	16	7
1980	86.0	67	6	21	6
1982	110.0	69	5	20	6
1982 debt service	11.5	24	6	49	21
Middle-income LDCs					
1971	24.0	45	8	33	14
1975	40.0	33	10	29	29
1980	107.0	25	10	28	38
1982	144.0	24	10	27	39
1982 debt service	23.5	12	9	36	43
NICs[c]					
1971	31.0	16	6	40	38
1975	72.0	9	7	24	60
1980	192.0	4	6	24	65
1982	266.0	3	6	24	67
1982 debt service	63.3	1	3	24	72
Non-oil LDCs (Total)					
1971	73.0	41	6	33	20
1975	152.0	32	7	23	38
1980	385.0	24	7	24	44
1982	520.0	23	7	24	46
1982 debt service	98.3	6	5	30	59

Notes

a. Source: OECD, *Development Co-operation: 1982 Review*, p. 237.
b. Non-concessional multilateral organizations.
c. Newly industrialized countries.

The balance-of-payments intermediation process which commercial banks assumed after the first oil shock was almost universally credited with having performed remarkably well.[7] The relative smoothness with which banks recycled funds from surplus to deficit countries largely contributed to the avoidance of major disturbances in the international monetary system and to a quick

adjustment of the world economy to the global payments imbalances. Yet only recently have the potential incompatibilities between the short-term objectives of private banks and the longer-term financial requirements of non-oil developing countries become clear, particularly in an environment of global recession. Not surprisingly, there is now widespread dissatisfaction with the way in which the international financial system has evolved as a framework for trade and payments.

The events of the last few years in the world economy have clearly proved the recycling strategy inadequate. The extent of the borrowing that took place and the constraints it has placed on the economies of non-oil LDCs threaten a serious crisis in the international financial market-place, with adverse effects on the world economy as a whole. Such developments, in turn, have fostered an acute awareness (as shown by the impressive amount of literature devoted to it in the past three years) of the need to address the question of the relative adequacy of existing recycling mechanisms in dealing with the nature and size of payments imbalances characteristic of the world economy. Indeed, the direction in which international banking has been heading and the exposure of the international banking sector to developing countries have now become causes for serious concern. Gone are the 'golden days' of recycling that characterized the 1974 – 78 period. As Henry Kissinger has observed:

> The energy crisis of the 1970s has turned into a parable on the fallibility of human foresight. Each party acting perfectly reasonably in response to immediate pressures nevertheless created an almost insoluble complexity. The passiveness of governments and the competitiveness of the banks solved an immediate problem by mortgaging the future.[8]

It might be useful, therefore, to investigate more fully the reasons underlying recent concerns expressed by Western bankers and government officials with regard to the future of private bank lending in the Third World. This equates to questioning the international financial community's repeated failures to address the structural weaknesses, apparent in the world economy as a whole and in developing countries in particular, of the privatization of the recycling mechanism.

Notes

1. A dramatic change has indeed occurred in the composition of financial flows to developing countries in recent years. In the mid-1960s, about 60 per cent of total financial resources transferred to LDCs were in the form of concessional official development assistance (ODA), with private sector flows (mostly in the form of export credits and direct foreign investment) accounting for the remaining 40 per cent. By the early 1980s, close to 70 per cent of resource flows to LDCs are of a commercial nature, predominantly in the form of private bank loans. (See Table 3-1, below.)
2. F. Stewart and A. Sengupta, *International Financial Cooperation: A Framework for Change*, p. 16.
3. Stewart and Sengupta, *International Financial Cooperation*, p. 14.
4. R. S. Weinert, "Banks and Bankruptcy", pp. 139–40.
5. The profitability of lending to LDCs also needs to be stressed. It has been estimated that international operations, of which lending to LDCs has been the leading component, produced over 95 per cent of the increase in total earnings for the nine largest United States (US) banks over the 1970-75 period. It should be noted, moreover, that international lending has proved less risky than domestic lending during the last decade: according to L.G. Franko and M.J. Seiber (eds.), in *Developing Country Debt*, losses on international loans have equalled roughly ⅓ of 1 per cent compared to losses of ¾ of 1 per cent on domestic loans.
6. Paul Watson, *Debt and the Developing Countries: New Problems and New Actors*, pp. 27–28.
7. See, for example, M.S. Mendelsohn, "New challenge for the recycling mechanism" and Yves Laulan, "Recycling oil surpluses: can the banks do it this time?"
8. H.A. Kissinger, "Saving the World Economy", p. 48.

3: *Recycling in the post-1973 Period: Evolution and Problems*

Recycling and the First Oil Shock, 1974–78

Although the cumulative current account deficit of non-oil developing countries reached the $180-billion mark over the 1974–78 period, it turned out to have been financed remarkably smoothly. Indeed, non-oil less-developed countries (LDCs), as a group, managed to add $39 billion to their reserves, which means that a net capital inflow of approximately $220 billion was transferred to them. New bank lending to these countries amounted to $90 billion during 1974–78, and these funds comprised 41 per cent of their overall financing needs.[1]

During this period, moreover, the developing countries were able to adjust relatively well to the turbulent conditions in the world economy, owing principally to their successful adjustment to relative price changes. Faced with sharply increased prices for their imports of fuels and manufactured goods, LDCs as a whole were able to cushion such adverse developments through increased efforts at import substitution and, especially, buoyant export growth and increased external borrowing.[2] Lower, real, oil prices from 1975 onward also contributed to the easing of such adjustment efforts. As a result, by 1978 the pattern of current account positions had returned to its pre-1973 form. Although the current account deficits of non-oil LDCs were about the same in nominal terms as in 1974,

they were smaller in real terms and as a proportion of the gross national product (GNP), which had grown in real terms at an annual average rate of 5 per cent.

It is against the backdrop of these overall trends in the economic performance of non-oil LDCs that we can best understand the international financial community's initial lack of concern towards the forms that the recycling process took. For one thing, in the early 1970s, private bankers generally viewed LDCs as being underlent. Given the depressed demand for loans from developed market economies, lending to the fast-growing nations of the periphery, that is, the so-called 'newly industrialized countries' (NICs), became a salient feature of portfolio diversification within the commercial banking sector. As the bulk of private bank flows was being lent to those countries whose capacity to service their debts was reflected in growing export volumes, few concerns were expressed about the adequacy of evolving recycling mechanisms. Moreover, attention paid to the high growth of LDC debt, following the first oil shock, tended to be tempered by the fact that outstanding debt had also doubled from 1969 to 1973, and that, in real terms, debt had grown more slowly in 1973–77 than in 1969–73.[3]

Furthermore, much of the increase in debt between 1974 and 1978 was inflationary, not real. During this period, indeed, LDCs were able to raise funds at largely negative real interest rates, which means that there was a real transfer of resources to debtor countries.[4] The overall debt burden faced by developing countries was thus considerably lower than it otherwise would have been. It has been estimated, for example, that the windfall gains conferred on developing countries through inflationary debt erosion were equal to about two years' worth of traditional concessional aid during the mid-1970s.[5] Moreover, because of the competitive pressures within Euro-currency markets, developing countries were able to borrow in excess of actual financing needs (that is, when the market was a 'borrower's' one). The increases observed in the levels of international reserves held by LDCs, which offset close to 30 per cent of the increase in total external debt during 1974–78, further reinforced the perceived adequacy of private bank recycling.[6] Given the prevalence of such conditions in the international economy, combined with the size and the speed of the financing that was required by deficit countries in the period immediately following the first oil shock, and in light of the 1976–78 recovery in the industrial economies, it is hardly surprising that few doubts were being cast upon the growing involvement of private banks in the recycling process.[7]

The increased availability of unconditional sources of financing from private banks, however, may have distracted the international financial community from advocating more involvement by official multilateral agencies, with the result that, as we saw earlier, such institutions played a relatively insignificant role in the overall recycling process. By the same token, the relative marginalization of multilateralism partly explains the lack of serious attempts to promote the reform of the international monetary system with regard to developing-country needs. This might have been done, for example, through the Special Drawing Rights (SDR) link, redefined conditionality practices, power sharing, and increased medium-term balance-of-payments support.[8]

Recycling and the Second Oil Shock, 1979–83

In sharp contrast to the 1974–78 experience, and in spite of continued improvements in both import and export propensities in many non-oil LDCs, the major impact of the overall adjustment process in the aftermath of the second oil shock has fallen on this group of countries' rate of growth, which experienced an almost fourfold decline during 1979–82. (See Table 3-1.) Drastically worsened conditions in the world economy, as reflected in growing structural imbalances in global payments positions, record high nominal and real interest rates, and the severity of the slow-down in the pace of activity in the industrialized economies changed the objective conditions in which the LDC debt problem came to be analysed.

Moreover, the absolute size of the non-oil developing world's financing requirements, as expressed by cumulative current account deficits (which amounted to $397 billion from 1979 to 1983) has, in light of the depth of the world recession, made such financing much more difficult than it was from 1974 to 1978. No restructuring has taken place, and traditional avenues of adjustment, such as reserve depletion, increased borrowing, or expanded export volumes have, for the vast majority of developing countries, become severely constrained since 1979.[9] Hence, given the pronounced shift towards the privatization of resource transfers to LDCs, the number of developing countries that are facing difficulties in servicing their bank debt as a result of acute balance-of-payments difficulties has recently risen sharply.

A more thorough understanding of the extent of the LDC debt 'crisis' is provided by the following figures. From 1973 to 1982, the

Table 5-1: *Trends in World Output, Terms of Trade and Payments Imbalances, 1973–1983*[a] (per cent changes and US $ billion)

		Changes from the Preceding Year (%)										
		1973	*1974*	*1975*	*1976*	*1977*	*1978*	*1979*	*1980*	*1981*	*1982*	*1983*
Real GNP[b]	(Av. 1963–72)											
Industrial countries	4.7	6.1	0.5	–0.6	5.0	3.9	4.1	3.5	1.3	1.6	0.1	2.3
Real GDP[c]	(Av. 1968–72)											
Oil-exporting countries	9.0	10.7	8.0	–0.3	12.3	6.3	2.3	3.7	2.0	4.0	4.3	1.1
Non-oil LDCs	5.9	6.7	5.5	4.4	5.5	5.7	6.4	5.1	5.0	2.8	1.5	1.6
Inflation (GNP Deflator)	(Av. 1963–72)											
Industrial countries	4.2	7.5	11.5	11.1	7.6	7.6	7.5	8.0	9.1	8.6	7.1	5.1
Consumer Prices	(Av. 1968–72)											
Oil-exporting countries	8.0	11.3	17.1	18.8	16.8	15.2	11.9	10.9	13.2	13.2	8.1	11.4
Non-oil LDCs	9.5	20.3	27.2	27.9	24.0	23.6	20.9	24.8	32.0	31.3	32.9	44.1
Terms of Trade	(Av. 1963–72)											
Industrial countries	0.3	–1.8	–10.6	2.5	1.0	1.2	2.8	3.4	6.8	1.5	1.8	2.1
Oil-exporting countries	0.5	13.3	140.0	–5.1	5.8	1.0	10.5	27.6	43.9	11.5	0.4	9.0
Non-oil LDCs	0.3	5.3	–5.9	–8.5	5.9	6.8	4.5	0.8	4.3	5.1	3.5	1.1
Current Account Balances												
Industrial countries		20.3	–10.8	19.8	0.5	2.2	32.4	5.4	40.4	1.9	1.4	1.2
Oil-exporting countries		6.7	68.3	35.4	40.3	29.4	5.7	62.5	111.0	53.4	12.0	16.2
Non-oil LDCs		–11.3	–37.0	–46.3	32.6	30.4	42.3	62.0	87.7	109.1	82.2	56.4

Notes:

a. International Monetary Fund, *World Economic Outlook 1984*. Adapted from C. S. Hardy, *Adjustments to Global Payments Imbalances: A Tripartite Solution* Working Paper No. 5 (Washington D.C.: Overseas Development Council, 1981).

b. Gross national product.

c. Gross domestic product.

ratio of debt service (interest and amortization as a percentage of exports of goods and services) has risen by more than 70 per cent, from 14.0 to 24.5 per cent. If short-term debt is included, the debt-service ratio has risen from 32 to over 70 per cent during 1977–82, indicating a much more severe deterioration than is shown by the more commonly used data on long-term debt.[10] Moreover, as Table 3-2 shows, cash-flow ratios (interest and amortization due on all debt, in relation to exports of goods and services) for some of the Third World's biggest debtors have exceeded 100 per cent; this means that banks have been getting back more money than they have been lending. Equally worrisome is the fact that the fraction of the non-oil LDCs' current account deficit absorbed by debt-servicing payments has risen from 46 per cent in 1974 to 131 per cent in 1982 and to 171 per cent in 1983. This means that "net lending today is grossly insufficient even for the servicing of old debt, let alone as a source of new resources for growth."[11] It has been estimated, moreover, that thirty LDCs have rescheduled bank debt since mid-1982, and that the bank lending has been providing a much smaller proportion of the combined figure of rescheduled loans surpasses the total for the previous twenty-five years.[12] By year-end 1983, thirty-two non-oil LDCs were in arrears on their debt-servicing payments; this situation represented another all-time high.

The problem, furthermore, is not merely the fact that an even larger proportion of new borrowings is being used to service past debts; it is rather that, given the problems of heightened sovereign risks and declining profits associated with Third World lending, downward trends in capital ratios and fears of over-exposure, the total level of new loans from the private banking sector is actually falling. Since 1980 there has, indeed, been an almost complete reversal of the financing roles of borrowing from private creditors and the combination of foreign direct investment and official transfers and lending. In 1980 net external borrowing from private creditors equalled 64 per cent of the sum of the current account deficits and reserve accumulations of the non-oil LDS's whereas foreign direct investment and official transfers and lending had a share of 45 per cent. By 1983 the share of net external borrowing from private creditors had fallen to 32 per cent, and that of foreign direct investment and official lending and transfers had increased to 70 per cent.[13] (See Table 3-3.) The rate of growth in bank claims on non-oil developing countries, which had averaged 24 per cent a year during 1978–81, declined to less than 2 per cent in 1982 and to 6.2 per cent in 1983.[14] Overall, bank lending has been providing a much

Table 3-2: *Developing-Country Bank Debt and Twelve Major Borrowers*[a]

Borrower	*Year-end disbursed debt*[b] *1982* ($ billion)	*Of which to bank, 1982* ($ billion)	*Total foreign exchange reserves 1982* ($ billion)	*Debt-service payments,*[b] *1982* ($ billion)	*Cash-flow ratio,*[c] *1982* ($ billion)
Brazil	72.6	43.9	4.0	18.1	122.0
Mexico	60.4	38.9	1.7	11.8	129.0
Argentina	27.1	15.5	2.7	6.3	179.0
Korea, Rep.	22.0	8.7	2.8	4.5	53.0
Indonesia	20.4	3.8	4.2	2.8	27.0
Algeria	16.8	3.2	2.6	4.6	39.0
Egypt	16.6	0.5	1.3	2.5	n.a.
Venezuela	16.5	12.9	10.0	5.2	95.0
Chile	13.4	8.5	2.5	2.4	116.0
Philippines	11.9	3.9	2.5	1.8	91.0
Peru	8.4	2.9	1.7	1.6	94.0
Nigeria	7.9	3.5	1.6	2.0	20.0

Notes

a. Source: OECD, *External Debt of Developing Countries: 1983 Survey*, pp. 76–77, and Overseas Development Institute, *Briefing Paper No. 2*, (March 1983), p. 2.

b. Figures relate solely to disbursed long-term debt as measured by the OECD and therefore understimate the overall debt burden faced by these countries.

c. Interest and amortization payments due on total debt (short- medium- and long-term) in relation to exports of goods and services.

Table 3-3: *Bank Lending to Non-Oil Developing Countries, 1978–82*[a]
(in billions of United States dollars and in per cent)

	1978	*1979*	*1980*	*1981*	*1982*
Bank lending to non-oil developing countries	25.0	40.0	49.0	50.0	25.0
Net oil exporters	5.0	10.0	14.0	19.0	7.0
Major exporters of manufactures	13.0	18.0	24.0	24.0	17.0
Low-income countries	2.0	3.0	1.0	1.0	—
Other net oil importers	9.0	9.0	9.0	7.0	1.0
Unallocated	–4.0	—	1.0	—	—
Bank lending as percentage of aggregate current account deficit	61.0	66.0	55.0	46.0	29.0
Net oil exporters	56.0	111.0	108.0	79.0	44.0
Major exporters of manufactures	130.0	82.0	70.0	63.0	50.0
Low-income countries	20.0	30.0	7.0	6.0	—
Other net oil importers	47.0	47.0	32.0	21.0	4.0
Share in bank lending to non-oil developing countries (in %) of					
Net oil exporters	19.2	24.8	27.8	37.5	29.8
Major exporters of manufactures	53.1	45.8	47.9	48.2	65.9
Low-income countries	6.5	6.8	2.9	1.3	–1.1
Other net oil importers	35.9	22.5	19.3	13.3	4.9
Unallocated	–14.7	–0.5	2.1	–0.3	0.5
Percentage increase in bank claims on non-oil developing countries	19.3	26.6	26.2	22.2	8.8
Net oil exporters	15.3	28.0	30.5	33.7	10.0
Major exporters of manufactures	22.5	25.9	26.9	22.8	12.6
Low-income countries	38.1	44.3	16.3	6.9	2.9
Other net oil importers	40.6	29.8	24.5	14.5	2.3
Memorandum items					
Increase in total net international claims of banks in the BIS reporting area (in %)	20.0	23.4	24.1	21.4	10.1
Share of non-oil developing countries in total net bank lending (in %)	27.7	32.0	30.6	30.3	26.3
Bank debt/exports	77.0	76.0	74.0	83.0	93.0
Growth rate of exports	15.0	29.0	26.0	5.0	4.0
Bank debt/imports	38.0	34.0	28.0	28.0	32.0
Growth rate of imports	19.0	30.0	29.0	6.0	10.0
Bank debt/GDP[b]	13.0	14.0	14.0	16.0	17.0
Growth rate of GDP	16.0	22.0	19.0	4.0	1.0

Notes

a. Source: International Monetary Fund, *International Capital Markets: Developments and Prospects*, pp. 25–26.

b. Gross Domestic Product.

smaller proportion of the financing needs of the non-oil developing countries than at any time since the early 1970s.

For developing countries exposed to severely depressed commodity prices[15] or oil revenues, and depleted reserves,[16] and with high real interest rates on considerable volumes of floating rate debt, the situation has thus reached a crisis state. The crisis has arisen from the fact that the prominence of interest charges and deterioration in their terms of trade have been absorbing borrowed funds, without increasing the real flow of external resources for development.

The problems associated with a privatized recycling mechanism are thus particularly obvious in the present state of global payments disequilibria. The banks are trying to scale down their involvement in Third World lending at a time when international economic conditions have shifted the bulk of current account-deficit pressures on the world economy's weakest link: that is, the developing countries. The deflationary bias that this lack of lubrication introduces in the world economy is by no means negligible. Under current conditions, however, there is no reasonable prospect that the large aggregate debt of LDCs will be repaid, which means, as the rescue packages have clearly shown, that banks are "collectively locked-in to LDC debt".[17] Consequently, continued attempts at retrenchment could precipitate the very troubles banks fear most. Indeed, not only does such a trend further increase the rash of debt reschedulings that have characterized the past few years, but it also hampers the prospects of developed-country recovery, as LDCs absorb fully 30 per cent of industrial country exports. For the United States, whose banks have the most at stake in Third World lending, this figure represents more than the United States exports to the European Economic Community (EEC) and Japan combined.

Under such conditions, and at a very time when the financing gap of developing countries has reached alarming levels, increasing doubts have arisen about the capacity of the actual institutional framework to deal adequately with the problems of development finance as they now present themselves.

The LDC Debt Crisis: Whose Fault?

The preceding section has shed some light on the forms which the developing world's external indebtedness problem has taken in the wake of the second oil shock. In descriptions of the overall weaknesses of the recycling mechanism, little attention has been focused

on the location of the sources of these weaknesses. In other words, why is there a 'problem' with private bank recycling, and how can the timing of the debt crisis be explained? Briefly stated, the answer appears to be essentially twofold:

- The LDC debt 'crisis' owes much of its acuteness to policy reactions to oil-shortage and inflationary pressures exerted by Western governments. Their policies have had perverse results for the world economy as a whole, and for developing countries in particular.
- The debt 'crisis' is reflected in the structure of multilateral institutions, a structure not designed to deal with the problems of 1973 and later.

Very clearly, the deflationary policies pursued by the industrialized countries in response to the second oil shock have invalidated the assumptions on which private bank lending had taken place.[18] In the pursuit of reducing inflation, Western governments have virtually decided to sacrifice world economic growth. While world deflationary policies have yielded quite significant results, their costs have not been negligible: unemployment and idle productive capacities have reached post-war heights; productivity has declined markedly in industrial and developing economies alike; and the international financial system has shown signs of worrisome vulnerability under the dead weight of external indebtedness and stagnating world trade.

The overall impact of global monetarism on Third World debt has been quite devastating. In 1981, for example, a combination of record-high interest rates and falling export prices produced an average real rate of interest of 30 per cent for non-oil LDC borrowers.[19] Even if annual fluctuations in prices are smoothed out, the adjusted real interest rate faced by LDCs in 1981-82 hovered around +8 per cent. The impact of higher interest rates varies considerably among borrowing countries. In general, however, with 75 per cent of LDC bank debt carrying floating interest rates, a 1 per cent increase in the London Interbank Offered Rate (LIBOR) has cost LDCs $3.4 billion (in gross terms) during 1981-82. In Brazil, interest payments alone accounted for 40 per cent of exports in 1982.[20] In addition, the past few years have witnessed a considerable growth in short-term debt, which increased from $39 billion in 1976 to $126 billion at year-end 1983; this growth has chiefly reflected heightened awareness of risks on the part of the banks. It is hardly surprising, therefore, that at present levels of real interest rates and declining export growth, the maturity profile of LDC external indebtedness has become unmanageable.

Institutional weaknesses in the international framework for financing and adjustment have also played a singular role in aggravating the actual crisis in development finance. Such weaknesses have been most conspicuous in three areas of critical concern to the international financial community. These areas are: the policy recommendations of multilateral institutions; the design of global adjustment mechanisms; and the inadequacies of existing official financing facilities.

Multilateral institutions, indeed, have been in the strange position of advising developing countries to solve their balance-of-payments deficits by deflation and devaluation, and by outward-oriented and export-led strategies, at the same time that restrictive monetary policies recommended for industrial and developing countries alike are making such adjustments all but impossible. If trade targets are mutually inconsistent, in the sense that most or all countries are aiming for a surplus, the process of adjustment becomes cumulatively deflationary for the world economy as a whole. Failure to recognize this fallacy of composition has been, and remains, a puzzling phenomenon.

A second major weakness relates to the actual design of adjustment mechanisms in the world economy. As the *Cambridge Economic Policy Review* recently pointed out, "the problem is not that the combined trade targets of different blocs are inconsistent in the sense of being too ambitious, but rather that adjustment processes [in their present form] are asymmetrical and non-uniform."[21] Lack of symmetry and of uniformity are most evident in the functioning of international financial institutions such as the International Monetary Fund (IMF) and the commercial banks. In the case of the IMF, this lack is reflected in the Fund's acceptance of persistent surpluses in the system, which shifts the burden of current account adjustment entirely on deficit countries. In the case of commercial banks, asymmetry and non-uniformity reflect themselves in discriminatory procyclical patterns of lending, which are based on the banks' perceptions of the creditworthiness of loan applicants.

Thus, in an already hostile, external economic environment, and in the absence of an institutional framework able to provide the necessary adjustments to be made in a context of growth, an inordinate share of the burden of adjustment in the world economy tends to fall on the non-oil LDCs and on their import capacities, thereby disrupting their growth processes. Moreover, since the shortfall in official balance-of-payments support has tended to be made up only through recourse to borrowing from private capital markets, the adjustment pressures have weighed most heavily on

those countries unable to secure access to such sources of financing: that is, the low-income developing countries. For the more creditworthy borrowers, the availability of financing has itself generated lagged adjustment problems arising from unmanageable debt-service burdens.

This last point raises the third major weakness in the institutional framework for recycling: the inadequacies of existing official financing facilities. The quantitative shortcomings of the official sector in financing developing-country deficits are well known and have already been discussed in the first part of this paper. The multilateral agencies' lack of financial resources poses an important qualitative problem in that, under current world economic conditions and within an international adjustment framework that already has a heavy short-term bias towards deflation, this lack can lead to the potentially inappropriate recourse to adjustment when the nature of the deficits encountered would call for much greater degrees of financing. This possibility, in turn, points to the multilateral agencies' (particularly the IMF's) lack of recognition for the scope and nature of the new form of payments imbalances that characterized the post-1973 structural deficits.

Structural deficits embody an LDC's need for significant adjustment of production — indeed, for a change in the structure of production, generally involving the substitution of domestic production for imports and expanding the export sector. Such an adjustment is needed to confront a change in the external environment that is not expected to be temporary, such as that caused by the rise in oil prices. Since this is an inherently lengthy process, requiring the fruition of medium- and longer-term investments, as well as the reallocation of domestic resources, it is therefore associated with a need for substantial financing.[22]

Failure to provide adequate facilities to deal with such imbalances[23] has thus made it all but impossible for less creditworthy LDCs to avoid the typically deflationary demand-management policies which the IMF has tended to impose on deficit countries, and for which it has been consistently criticized.

A final point relates to the marked tendency in the literature to identify equilibrium in the current account as the proper goal of adjustment policies. This objective, however, fails to take into account the fact that most developing countries should, under normal circumstances, be net recipients of long-term capital flows. Indeed, because of their generally low income levels and their persistent growth of population, one would expect to see the LDCs' need for rapid internal expansion as somewhat incompatible with

balance in external trade. In practice, LDCs should be able to incur larger trade deficits if only these could be financed safely, that is, without undue damage to the service component of their current accounts. However, since the present international financial environment does not provide such an opportunity, it follows that the 'problem' of development finance (of which the external indebtedness crisis constitutes the most acute manifestation) can be treated analytically as a transfer problem. When one remembers that the industrial economies now constitute the source of current account surpluses in the world economy, the functioning of the actual recycling mechanism raises a question with strong developmental connotations. Indeed, it is worth asking whether there is any logic in a world system which permits surplus countries to shift the burden of world anti-inflationary policies to countries which, despite their low levels of income, must, in addition, accept the transfer of their real resources abroad, be it in the form of increased debt-service payments or through declining terms of trade. In other words, "If the materially strongest countries in the world seek to get rid of their deficits, what hope is there for the weaker countries?"[24]

As our discussion of the asymmetry of present-day adjustment mechanisms has made clear, the ex post trade balance of LDCs is governed, in the long run, entirely by financial constraints.[25] Yet it is not at all obvious that developing countries should systematically be made to adjust to exogenously induced deficits, particularly when such deficits might turn out to be of an essentially temporary nature[26] (that is, should commodity prices be depressed or should real interest rates be abnormally high) and when sufficient bridging finance is not forthcoming (that is, given the structural nature of the deficits). That developing countries are forced to assume these burdens now is but the outcome of an international framework for recycling and adjustment which, under the tutelage of global monetarism, has proved itself inadequate for creditors and debtors alike.

Although it seems fair to ascribe the developing world's indebtedness problems predominantly to the external factors which have previously been identified, it is none the less obvious that the debt problems faced by many non-oil LDCs have been aggravated by inappropriate fiscal (particularly in the realm of public sector enterprise financing and management), monetary, and exchange-rate policies. This poor policy mix engendered by some LDCs has given partial credence to the fact that the opening up of international financial markets since the early 1970s might have contributed to the financing of untenable consumption levels. This development

has, in some instances, altered the desirable mix between adjustment and financing towards the latter element.

However, while the overall management and instrumentation of LDC borrowings have been highly diverse, empirical evidence indicates that non-oil LDCs have generally achieved high rates of allocational efficiency in their use of financial resources.[27] For example, internally generated savings as a percentage of gross domestic product (GDP) increased from roughly 18 per cent in 1960 to over 25 per cent in 1980. Moreover, non-oil LDCs, as a group, have diverted a greater share of their cash flows towards investment than have industrialized countries. Real domestic investment among non-oil LDCs increased at an annual rate of 8.7 per cent over the 1960–80 period, as opposed to 4.4 per cent for countries that are members of the Organisation for Economic Co-operation and Development (OECD).[28] As some observers recently put it: "When debt of the 15 major borrowing nations is compared to their growing economies and international trade, it may be questioned whether many countries in fact overborrowed up to the period of the recession."[29]

In the aggregate sense, therefore, it is wrong to view the LDC debt problem as one of domestic mismanagement and/or overborrowing. Rather, the 'problem' reflects the accumulation of assets whose maturity profiles were based on streams of income — and hence of export performance — which have not materialized, primarily because of a sudden change from inflationary boom to deflationary recession in the advanced market economies. This was a change the severity of which was largely unanticipated.[30] As one recent study forcefully concluded:

> . . . a very large part of the increase in developing-country debt in the last decade may be attributed to the impact of global causes that were exogenous to the developing countries themselves: higher oil prices beginning in 1973 and, in 1981-82, abnormally high interest rates and declines in terms of trade and export volume associated with global recession.[31]

Notes

1. R. Solomon, "The Debt of Developing Countries: Another Look", p. 595.
2. Aggregate figures, however, can prove to be misleading, as unequal access to external borrowing and uneven potentialities at restructuring have left the majority of low-income LDCs with far more severe for-

eign exchange constraints. In such cases, income adjustments were unavoidable. More on this later.

3. See M. Katz, *Capital Flows and Developing Country Debt*, p. 43.
4. G. R. Kincaid, "Inflation and the External Debt of Developing Countries", p. 44.
5. See W.R. Cline *et al.*, *World Inflation and the Developing Countries*, p. 28.
6. See M. Seiber, *International Borrowing by Developing Countries*, p. 44.
7. See, for example, R. Solomon, "A perspective on the debt of developing countries".
8. It should be remembered that much of the of the attention of the International Monetary Fund (IMF) during the 1974–76 period was focused upon the ongoing reforms in its Articles, following the final abandonment of the Bretton Woods system in 1973, which led to the Jamaica Agreements of 1976. This partly explains the IMF's initially marginal involvement in the recycling process.
9. See S. Griffith-Jones, *The evolution of external finance, economic policy and development in Chile, 1973–78*.
10. W. R. Cline, *External Debt and Financial System Vulnerability*, pp. 3–4.
11. Cline, *External Debt*, pp. 3–4.
12. "While complete information is not available on each rescheduling, the 30 cases combined are estimated to represent a rescheduling of over $80 billion of principal repayments into long-term obligations. At least one half of this amount originally due between mid-1982 and mid-1984 concerns long-term obligations; the remainder, short-term debt." Organization for Economic Co-operation and Development, *External Debt of Developing Countries: 1983 Survey*, p. 49.
13. These shares do not sum up to one, since there are other (often negative) items such as errors and omissions and the use of the International Monetary Fund credit.
14. International Monetary Fund, *International Capital Markets: Developments and Prospects, 1984*, p. 3.
15. By the end of 1982, commodity prices (excluding oil) were at their lowest levels in real terms for thirty years. In 1982 alone, the *Economist's* all-items commodity index, denominated in Special Drawing Rights (SDRs), fell by nearly 25 per cent.
16. For the energy-importing group as a whole, reserve levels would support only two-and-a-half months' imports at year-end 1981. As recently as year-end 1979, reserve coverage had been 3.8 months. All together, reserve levels at the end of 1982 were $40 billion below those at the end of 1980, and fully 30 per cent of energy importers were unable to cover even one month's imports, as reported by the Overseas Development Institute (ODI), in March 1983.
17. D.T. Llewellyn, "Avoiding an International Banking Crisis", p. 33.

18. Namely, continued LDC export growth and a serviceable debt profile, both in terms of maturities and interest-rate levels, which, considering the size of the surplus of the Organization of Petroleum Exporting Countries (OPEC), could have proved less problematic had member governments of the Organisation for Economic Co-operation and Development (OECD) pursued a different policy approach. On this, see T. Balogh and A. Graham, "The Transfer Problem Revisited: Analogies Between the Reparations Payments of the 1920s and the Problems of OPEC Surpluses".
19. Overseas Development Institute, *Developing Country Bank Debt*, p. 4.
20. Overseas Development Institute, *Developing Country Bank Debt*, p. 4.
21. Paul Atkinson *et al.*, *World Trade and Finance: Prospects for the 1980s*, p. 26.
22. J. Williamson, *The Lending Policies of the International Monetary Fund*, p. 17.
23. When the International Bank for Reconstruction and Development (World Bank) started its Structural Adjustment Loan (SAL) program in 1980, the program was geared in this direction, but the amounts made available have been rather small: a ceiling of 10 per cent of gross World Bank lending has been set for SAL programs. The IMF's Extended Facility, created in 1974, was intended to address structural problems, but has generally failed to recognize the need for substantial financing in complementing adjustments efforts. For more on this, see Williamson, *Lending Policies*, pp. 11–24.
24. Balogh and Graham, "The Transfer Problem Revisited", p. 191.
25. Atkinson *et al.*, *World Trade and Finance*, p. 25.
26. See G.K. Helleiner, *The IMF and Africa in the 1980s*, pp. 23–24.
27. See E.L. Bacha and C. F. D. Alejandro, *International Financial Intermediation: A Long and Tropical View*; and A. Martens, *Le problème de la dette extérieure des pays en voie de développement : faits et remèdes possibles*.
28. World Bank, *World Development Report* (1982), p. 35.
29. W.H. Bolin and J. Del Canto, "LDC Debt: Beyond Crisis Management", p. 1103.
30. Pedro-Pablo Kuczynski, "Latin American Debt".

4: *The Developmental Adequacy of Private Bank Recycling*

As the preceding section has attempted to make clear, the source of the Third World's debt crisis lies in the structural weaknesses and in the progressive deterioration of the international economic environment, upon the favourable evolution of which the growth-cum-debt strategy had been predicated. The foolishness of some banks and the lack of financial responsibility of some borrowing countries have, obviously, played a part in the international financial crisis. None the less, such factors can hardly be described as prime causes of the crisis. Indeed, it should be remembered that the so-called 'bankers' sin' was generally committed at everyone else's request and was received with general applause while the lending and borrowing appeared to function smoothly.

However, inasmuch as under the most optimistic assumptions about the growth of alternative forms of financing, the commercial banking sector will have to handle over 50 per cent of the recycling needs of developing countries until the mid-1980s,[1] the assessment of the developmental adequacy of private bank flows to developing countries is of critical importance in helping to explain some of the long-run dynamics of foreign indebtedness. In the past few years, a considerable amount of literature has been devoted to this specific aspect of the Third World-debt problem, some of which, particularly on the part of authors associated with the dependency school, has expressed serious concern about the participation of private banks in the financing of development.

One major criticism of the role of private bank credits in the funding of development has been that access to Euro-market loans does not reduce, but merely changes, the nature of financial dependency: "It is in this aspect, . . . the overbearing and implacable necessity to obtain external financing, . . . which finally sums up the situation of dependency."[2]

Yet, apart from the problems connected with the exact conceptual meaning attached to the notion of financial dependency (something which is rarely, or never, made clear in the literature), it is possible to show that the evidence given to support this view is somewhat less than convincing.

For example, it is argued that a country's desire to attract private loans might encourage it to form a policy which puts undue weight on financial or external variables such as the balance of payments or the accumulation of reserves as opposed to more developmental objectives. However, it has been pointed out in a study of Latin American indebtedness:

> An examination of the Region Latin America and certainly of the world more generally indicates that lending takes place to a wide variety of political regimes, pursuing extremely diverse economic strategies and amongst which financial orthodoxy hardly prevails.[3]

Indeed, some of the big borrowers, particularly among some oil-exporting countries, but also among a wide variety of other major bank debtors, by pursuing what could hardly be called orthodox economic policies, have sought to promote rapid industrialization, while at the same time devoting massive investments to infrastructural development.

Another criticism of the dependency aspect associates private bank lending with the propping up of repressive regimes "whose socio-economic policies are not characterized by a primordial concern for social justice and economic and political participation".[4] On this, two points need to be made. First, while access to private financing is often correlated with the implementation of economic policies which seem more feasible under authoritarian regimes,[5] the reverse of the proposition, which implicitly seems to assume a positive correlation between financial autonomy and/or self-reliance and open political regimes,[6] is open to suspicion, particularly regarding the real-world feasibility for so-called 'financial self-reliance'. Secondly, it is worth asking whether those countries that have not made external borrowing a salient feature of their develop-

ment strategies have systematically performed better in the provision of basic needs and in respect of human rights.

Critics in the dependency tradition have also linked the privatization of the recycling mechanism to the different sources of surplus transfer, at both the macro (that is, in centre-periphery terms) and the micro (that is, in terms of the allocative rationality of the international banking system) levels. At the macro level, private bank lending and its associated debt-servicing payments have been seen as a source of surplus transfer "which reduces the level of investible surplus below what it might be and thus slows down the pace of industrialization and structural change in the periphery."[7]

As shown earlier in this paper, because of dramatic and unforeseen fluctuations in the level of real interest rates, less-developed countries (LDCs) have had to face, in recent years, quite unprecedented cutbacks in their overall growth levels, as the pace of net bank loans has not kept up with the exigencies of servicing them. In the process, they have effectively been transferring abroad sums in excess of the net financial flows received. However, in ascribing to private bank recycling what have clearly been the perverse manifestations of an induced world recession, such analysis appears rather spurious. For one thing, it fails to recognize that for the greater part of the 1970s, because of rising export volumes and prices and negative real interest rates, a net transfer to debtors actually occurred. Moreover, it runs into an important problem of counter-factuality. Indeed, it fails to acknowledge the fact that if bank lending had been significantly smaller, the oil-importing LDCs would have been forced to adjust through even more severe restrictions on aggregate demand — a situation which was particularly acute for non-creditworthy borrowers — with potentially even greater effects on the deceleration of growth levels within the Organisation for Economic Co-operation and Development (OECD). The relevant comparison, therefore, is between the problems which would have accompanied that alternative and the debt problems being faced today.

In addition, such surplus transfer propositions are often open to objections concerning the way in which the amounts of these transfers are measured. In the case of foreign loans, to compare the initial sum lent with the sum of amortization and interest payments as evidence of surplus transfers fails to take into account the dynamic effects that such loans may have produced.

> In ignoring both the physical impact of a foreign loan — its contribution to increased physical production and/or ex-

> ports — and its structural effects (such as changes in the internal division of labour, growth of the internal market, local acquisition of skills), such purely "monetary" and "international exchange" theories of surplus transfer can degenerate into a rather weak-minded economic nationalism.[8]

While there is no automatic link between import capacity and economic growth, which is influenced by numerous other factors, it is not a coincidence that output has consistently grown fastest in countries in which foreign financing has permitted expanding import volumes over the 1970–80 period. In complementing domestic savings and, primarily, in relieving the foreign exchange constraint (given the relatively fixed nature of short-term import and export propensities), as well as by enabling growth to be maintained even in the face of large payments imbalances, creditworthy LDCs have been provided, through access to private bank credits, with a significantly wider variety of options than they previously had for selecting development strategies. Not surprisingly, developing countries which were able to tap the Euro-markets have generally tended to experience some of the most pervasive manifestations of socio-economic structural change. Hence, to argue that over the past decade, the developing world has increased its debt without increasing its capacity to repay it[9] is to profess a somewhat disquieting line of economic reasoning.

At the micro level, critics of the recycling mechanism have contended that private financial flows contribute to uneven development within the Third World,[10] a phenomenon which proposals for greater transfers to LDCs, and particularly to the newly industrialized countries (NICs), would therefore reinforce.[11] It has also been argued[12] that because a significant number of developing countries, particularly among the low-income and oil-exporting groups, are net Euro-market depositors, the Euro-currency market appears to be transferring financial resources away from the poorer developing countries and towards the richer ones. Again, such assertions fail to impress in light of accumulated evidence.

For example, Latin American countries' debts were roughly proportional to gross domestic product (GDP), and access to foreign finance did not, therefore, really confer differential advantages on specific countries and so contribute to uneven development.[13] Obviously, Euro-market recycling creates problems in so far as it is exceedingly unequal and geographically concentrated, particularly in net terms.[14] There is, however, a need to relate the skewedness of the banks' global lending patterns to that observed in all forms of

private lending, in domestic markets, for example, where the bulk of depositors are net lenders to the banking system. Moreover, even if this is true, the scale of such transfers is so low as to make them insignificant.[15]

To criticize private bank recycling on the ground of its contribution to a widening of the heterogeneity characterizing the Third World is of little analytical relevance, inasmuch as it is clearly not the job of international banks to arrange their portfolios so that LDCs can meet their development needs or to 'internalize' global welfare functions in their lending policies. (Nevertheless, it is precisely for this type of reason that the failure of multilateral institutions to respond to the requirements of development finance in the post-1973 period looms so large in the actual debt crisis.) Furthermore, it is not clear that homogeneity in the Third World is a concept which makes much sense, considering the vastly divergent potentialities and factor endowments possessed by different nations of the 'periphery'. In other words, there is every reason to believe that any form of resource-transfer mechanism would have resulted in a greater share of flows going to the fastest-growing LDCs.

On the whole, therefore, it can be said that the analysis of the Third World's debt crisis which proponents of the dependency school have put forward has generally failed to shed light on what appears to be its root causes, as well as on some of the most relevant dynamic interactions between external indebtedness and long-term development and structural change.

This should not suggest, however, that the privatization of the LDC debt structure is problem free, particularly in terms of its short-run sustainability. For one thing, floating-rate bank loans not only expose debtors to uncertainties as to the speed at which their debt will be amortized in real terms, but also complicate investment decisions and the analysis of future inflows of external debt because a new factor must be considered: industrial country monetary policy. The viability of past investments may be hampered as higher rates of return are required to match the increased real interest costs. Similarly, the variablity of real interest-rate levels compounds the planning problems associated with external borrowing.[16] Moreover, in view of the pervasive and fundamental role of international banking in the world economy, issues naturally arise concerning the limits to its growth, and how the system can be controlled in the interests of financial stability. In a very real sense, the international financial system has become a network of international banks whose scale of operations and capacity for reserve creation escapes the direct control of the institutional authorities

responsible for keeping the system on an even keel. In other words, the international financial system has taken on some of the characteristics of a domestic credit system, without a central bank.[17] From the point of view of the world economy, the key question is whether self-regulation by the banks represents a sufficient control and stablilizing influence in the international financial system. For developing countries, the 'appropriateness' of future commercial bank lending is likely to be a reflection of the conditions under which and the extent to which a predominantly privatized recycling mechanism is made to operate.

Considering the extent of external financing requirements to be faced by LDCs in the medium term, the general outlook for LDC debt-servicing, and the constraints likely to be felt by private banks in meeting these requirements on the same scale as in the past, a satisfactory outcome to the Third World's external indebtedness problem is unlikely if resource flows are to be left chiefly to the private sector. It is quite clear, indeed, that because of the skewedness and procyclical tendencies of present-day recycling arrangements, private banks simply do not offer a viable lending policy for the long run. This situation raises the need for reform in the areas of recycling and development finance.

Notes

1. R. O'Brien, *Private Bank Lending to Developing Countries*, pp. 29–37.
2. O. Sunkel, as quoted in S. Griffith-Jones, *The evolution of external finance, economic policy and development in Chile, 1973–78*, p. 3.
3. J.R. Wells, *Latin America in the World Economy of the 1980s: the foreign debt issue*, p. 42. Mimeo.
4. R. Devlin, "Commercial Bank Finances from the North and the Economic Development of the South: Congruence and Conflict", p. 76.
5. The causation could as well be said to run from restrictive world monetary policies to authoritarianism, instead of from private bank loans to repressive regimes.
6. D. Seers, "Massive Transfers and Mutual Interests", p. 558.
7. G. Corm, "The Indebtedness of the Developing Countries: origins and mechanisms", pp. 15–110.
8. Gavin Kitching, *Development and Underdevelopment in Historical Perspective: populism, nationalism and industrialization*, p. 167.
9. Chandra Hardy, *Adjustments to Global Payments Imbalances: A tripartite solution*; and F. Saddy, "OPEC Capital Surplus Funds and Third World Indebtedness: The recycling strategy reconsidered".

10. S. Griffith-Jones, for example.
11. Seers, "Massive Transfers", p. 557.
12. See A.G. Frank, *Crisis in the Third World*; G. Bird, "Financing Balance of Payment Deficits in Developing Countries: the roles of official and private sectors and the scope for co-operation between them"; P. Engellau and B. Nygren, *Lending Without Limits: On International Lending and Developing Countries*.
13. Wells, *Latin America in the World Economy of the 1980s: The Foreign Debt Issue*. Mimeo.
14. T. Killick, "Eurocurrency market recycling of OPEC surpluses to developing countries: fact or myth?" For example, Killick estimated that at year-end 1979, 99.7 per cent of net Euro-currency recycling was accounted for by a mere five countries: Argentina, Brazil, Liberia, Mexico and South Korea.
15. See Killick, "Eurocurrency market recycling", p. 98.
16. B. Nowzad, "Some Issues and Questions Regarding Debt of Developing Countries", p. 167.
17. G. Carli, *Why Banks are Unpopular*, p. 8.

5: *Reforms in Recycling and Development Finance*

In seeking solutions to the Third World's external indebtedness problem, the immediate interests of commercial bankers and of Western governments lie in remedies that can prevent less-developed-country (LDC) debtors from defaulting. The interests of developing countries, on the other hand, lie in remedies that ensure a continuing net flow of funds to sustain economic growth. Such interests may ultimately be made to coincide, but they are not identical. It is quite obvious, for example, that most of the short-term emergency measures implemented by industrial countries in recent months have been taken rather to protect the international banking system than to safeguard the LDC debtors.[1] The time has come, however, to go beyond the simple putting out of fires where they break out and to avoid making debt-rescheduling the "most profitable game in town".[2]

There have been ample proposals for alternative recycling strategies from which to choose and shape a policy package. Such a package ultimately should revolve around three broad objectives. One objective relates to the need to assure continuing intermediation in financial markets to prevent drastic declines in net bank lending to deficit countries[3] and prohibitive declines in world income. A second objective concerns the restoration of a better balance between private and public sources in the recycling process, thereby reducing the exposure of the former while strengthening the influence of the latter. A third is the obvious need for industrial

country policy to provide faster growth and lower interest rates, thereby permitting an expansion in LDC exports sufficient to allow the resumption of sustainable debt servicing.

More specifically, it is essential that four problem areas in development finance be addressed. These are the maturity structure of LDC external debt; the need for a greater degree of flexibility in the framework for adjustment and financing; the future role of multilateral lending agencies; and the prospects for concessional financing.

The major problem with Third World bank debt is that too much of it is bunched with short maturities carrying high and floating interest rates; it is the cumulative impact of these circumstances that has fostered the actual crisis. Ways must thus be found to avoid the present risk of defaults by relieving developing countries of the debt they are unable to service without major disruption to their own economies. One way of doing this entails transforming the maturity structure of present indebtedness, that is, converting short-term debt into longer-term debt. To accomplish this, various sources have proposed the establishment of a rediscounting mechanism.[4]

Essentially, the mechanism implies that a multilateral lending agency, such as the International Bank for Reconstruction and Development (World Bank) or a regional development bank, would buy at a premium debts owed by LDCs to banks and, in return, issue bonds which the multilateral agency or the LDC governments would guarantee. The debts could then be renegotiated with longer maturities and lower (or fixed) interest rates between the agency and the developing countries concerned. Part of the cost of such an operation would thus be paid by the participating banks, which would thereby incur partial losses.[5]

Such an infusion of long-term lending, by alleviating debt burdens that weigh heavily on growth prospects, would obviously be quite appealing to LDCs. Similarly, such an arrangement would be satisfactory to Western governments, since it would not require taxpayers' money to bail out the commercial banks.[6] The proposal's attractiveness to private banks, however, is less obvious, as it is bound to vary considerably among different banks. Although, for many commercial banks, it might represent an interesting alternative to writing off bad debts or to bearing the burden of repeated reschedulings, it is doubtful whether such a mechanism could be counted upon to generate new loan commitments from the private banking sector. Theoretically, the reduced exposure of commercial banks would permit them to continue to play a role in expanding credit on their own account. Yet, "How many boards of directors would be

responsive to programs of new loans for borrowers whose existing loans — and potentially future loans — were subject to arbitrary judgments requiring write-off?"[7]

Finally, the lack of interest within the multilateral lending agencies themselves, in response to calls for a rediscounting mechanism, seems to preclude any attempt at alleviating the LDC debt problem through such channels. As long as creditor countries continue to view the problem of LDC external indebtedness as one of temporary illiquidity, calls for write-offs or stretch-outs are more than likely to fall on deaf ears.[8]

As shown earlier, the international framework for adjustments to and financing of payments imbalances suffers from two critical weaknessess, which must be overcome. First, since this framework is chiefly a function of the credit rating of the commercial banking sector, it provides financing to only a handful of deficit countries which, under current conditions, have run into a crisis of debt servicing. Secondly, it places the bulk of adjustment pressures on those countries whose capacity to adjust is weakest. Attention must therefore be given to the introduction of a much greater degree of flexibility in the operation of this framework.

In considering the steps to be taken in dealing with pressures on the balance of payments, the international financial community must distinguish more fully than it has in the past between those sources of pressure that call for adjustment by the countries concerned, and those sources that indicate mainly a need for financing, but not necessarily a need for domestic adjustment. The former case, moreover, involves a need to recognize the structural nature of the deficits to which many LDCs must likely adjust; these adjustments, themselves, call for the provision of significant financing. The latter case focuses upon the need for the fuller financing of deficits which are exogenously created and are ostensibly temporary in nature.

The key to creating a more flexible adjustment mechanism also lies in the recognition that the capacity for adjustment varies widely among developing countries. That capacity depends upon a country's level of reserves, its creditworthiness, and its access to external borrowing, as well as on its ability to raise exports and curtail or substitute imports. Hence there is need for adjustment policies to be adapted accordingly.[9] As the latest report of the Independent Commission on International Development Issues (the Brandt Commission) stated, "Uniformity of treatment means like treatment for like cases, not identical treatment for all cases."[10]

In light of the shortcomings that we have just traced in the framework of development financing, there is now a widely perceived need for a significant strengthening of the multilateral agencies' lending capacities to enable them to make a growing contribution to financing LDC deficits and, ideally, to make it possible for a mid-course correction to reduce the proportion of private bank debt in total debt. The main advantage of such a shift resides in the fact that official lending agencies are able to distribute both concessional and non-concessional funds among recipient countries according, mainly, to development capacities and needs, and not according to the narrowly focused political objectives of particular donor governments or to the requirements of private lenders seeking predictable returns from lower-risk borrowers.

The most obvious choice to play an enlarged role in deficit financing is undoubtedly the International Monetary Fund (IMF). Since 1973, in a variety of ways, the Fund has sought to adapt to the new problems of development finance. None the less, its retreat[11] from anticyclical policy in the aftermath of the second oil shock has had the net effect both of seriously drying up its reserves[12] and of exposing fully the extent of what has been called its 'constrained flexibility', that is, its generally unsuccessful alteration of stabilization programs to accommodate the changed forms of adjustment of the mid-1970s and later.[13]

Assuming that some degree of relaxation could be restored to the monetary policies pursued by Western governments, the IMF should seek to play a more central role in the overall recycling process, particularly in providing greater financial support for typically less-creditworthy borrowers. Thus,

> By implication, the Fund might reasonably be restricted to the role of lender of last resort for the countries able to tap bank credit, but preventing the Fund from being a lender of first resort to the noncreditworthy countries would deny them any borrowing other than last resort.[14]

Recent empirical work has shown the extent to which terms of trade deterioration have played a crucial role in determining non-oil LDC payments imbalances.[15] Therefore, at a time when most developing countries have been facing severe declines in the traded value of their commodity exports, it is unfortunate that the IMF's Compensatory Financing Facility (CFF) has played only a marginal role in alleviating deficit pressures beyond the control of most primary commodity-exporting LDCs. For example, it has been estimated that the CFF supplied to Sub-Saharan Africa only ½s of the

finance that would have been required to offset the deterioration in this group of countries' terms of trade in 1980–81.[16] An expansion of IMF credit, not only to compensate for shortfalls in nominal export proceeds, but also to offset more fully adverse changes in the terms of trade (particularly for lower-income countries) could meet the need for greater infusions of official flows carrying lesser degrees of conditionality.

A compelling case can therefore be made for substantially larger increases in the IMF's loanable resources if the Fund is to provide more than mere confidence to the international financial system and effectively assume greater responsibilities in dealing with the numerous manifestations of the Third World's resource-transfer problem. Perhaps the most efficient way of raising capital would be for the Fund to intensify its direct borrowing from surplus countries and extend such practices to the private capital markets. Given the disparity between IMF resources and the size of LDC debts, it is somewhat disconcerting that few, if any, steps have been taken in this direction.

If the external financing needs of non-oil LDCs are to be met more adequately in the future, there must also be significant increases in the provision of medium- and long-term-program lending. Financial assistance for more general purposes is, of course, provided to LDCs by the IMF and the commercial banks, but this assistance tends to carry relatively short maturities. Thus there is a gap in the provision of medium- and longer-term general purpose finance, which multilateral lending agencies such as the International Bank for Reconstruction and Development (World Bank) and regional development banks could fill. Such institutions, however, have suffered from a number of shortcomings in recent years, namely, the lack of automatic funding mechanisms, increased wariness on the part of donor countries, and the general shift away from multilateralism. Policies designed to provide more adequate repienishment procedures for these institutions — an acute problem in recent years for the World Bank's soft loan affiliate, the International Development Association (IDA) — require much greater degrees of co-operation among creditor countries.[17] The World Bank, in particular, should adopt a more liberal and realistic gearing ratio of ensured loans to capital. This ratio is presently one to one, whereas it is in the range of twenty to one for a typical commercial bank. A much greater emphasis also needs to be placed on the World Bank's Structural Adjustment Loan (SAL) programs which, despite addressing themselves to one of the major problem areas in development finance, have not received the financial resources they warrant.

Another theoretically interesting avenue to tapping Euro-market funds without increasing the banking sector's overall exposure in LDCs would be for multilateral lending agencies to provide a scheme of guarantees or insurance against country risk. Several proposals of this type have been put forward in recent years and deserve greater attention.[18] Similarly, industrialized countries could do much to revive the sagging spirits of their capital goods industries by increasing the lending capacity of national export credit agencies, thereby avoiding disruptions in key LDC growth industries and sectors. Steps of this kind, relating to Brazil and Mexico, have already been taken by the United States (US) Export-Import Bank.

For the low-income countries, access to sources of external financing other than official development assistance (ODA) is extremely limited. It is a serious concern to them, therefore, that their share of external finance received by all non-oil LDCs fell from 16.9 per cent in 1973 to 14.3 per cent in 1981.[19] Moreover, despite growing consensus, among developed and developing countries alike, that concessional resource flows should go mainly to the poorest countries, low-income LDCs received only 37 per cent of total aid from the Organisation for Economic Co-operation and Development (OECD) and the Organization of Petroleum Exporting Countries (OPEC), and less than two-thirds of total (bilateral and multilateral) aid at the beginning of the 1980s.[20]

Since most low-income countries obtain close to 90 per cent of their medium- and longer-term financial flows from official sources, their debt burdens have typically not been very large in absolute terms. Relative to their levels of trade and output, however, and in light of the adjustment pressures they have faced since the mid-1970s, the size of their deficits, in actual terms, is quite large.

One of the most serious probems in development finance, and potentially the most difficult to overcome, is thus the need to provide low-income developing countries with substantial increases in concessional aid levels. Considering the budgetary pressures faced by Western donor countries and the confused state of world oil markets, the task of making such provision is clearly a difficult one. Yet it should be remembered that even a doubling of ODA to today's low-income countries would be equivalent to less than one-quarter of 1 per cent of the combined gross national product (GNP) of OECD countries.[21]

Notes

1. Indeed, a persistent criticism of the present system is that its outcome is geared to what may be called commercial considerations, that is, elimination of areas, restoration of regular payments, rescheduling on commercial terms, and restoration of creditworthiness, as against more 'developmental' considerations, embodying the restoration of a sustainable long-term development path. The practical implications of the latter approach have never been truly elaborated, but they could include, along with other means, a combination of rescheduling with injection of new funds, particularly from the Overseas Development Administration (ODA), for low-income countries; longer periods of repayment; terms of rescheduling geared to income level; or export performance of debtor countries.
2. A. Bressand, " 'Mastering the World Economy'", p. 765.
3. As mentioned previously, the 1982 total of net new bank lending to the non-oil developing countries amounted to less than one-half of the 1981 total. Such a trend appears to have continued throughout 1983, as first-quarter figures indicate that commitments to Mexico and Brazil alone accounted for about 80 per cent of new commitments to non-oil LDCs. (See International Monetary Fund, *World Economic Outlook*, 1983, p. 7.) Such commitments, moreover, could be characterized as involuntary lending, insofar as they have been granted as part of rescue attempts enforced by the IMF.
4. See F. Rohatyn, "The State of the Banks"; P.B. Kenen, "A Bailout Plan for the Banks"; Independent Commission on International Development Issues, *Common Crisis North-South: Co-operation for world recovery*; and R.S. Weinert, "Banks and Bankruptcy".
5. There is no doubt that some banks, because of generally foolish lending policies, would be forced to forfeit a part of the value of their loans. This may not, however, be the best time to establish such a principle, when an excessive cutback in lending to LDCs is the chief danger. The rediscounting proposal is all the more appealing in this circumstance.
6. For a clear exposition of American 'neo-populist' opposition to the concept of bailing out banks, see L.C. Thurow, "If the Debtors Default" in *Newsweek*, 21 February 1983, p. 37.
7. W.H. Bolin and J. Del Canto. "LDC Debt: Beyond Crisis Management", p. 1104.
8. W. R. Cline, *Developing Country Debt under Alternative Global Conditions: 1983–86*, p. 2.
9. An interesting proposal in this sense has been made by Sydney Dell who argues that the conditionality applied by official lending agencies (particularly the IMF) could be made to vary, depending upon the source of a deficit: that is, whether or not the source's origin is endogenous. On this, see J. Williamson, *The Lending Policies of the International Monetary Fund*, pp. 11–12.

10. Independent Commission, *Common Crisis*, p. 63.
11. As reported by G.K. Helleiner, *The IMF and Africa in the 1980s*, p. 19, such a 'retreat' can be seen in the fact that in the first six months of 1982 (that is, during the worst recession since the 1930s), the IMF's new commitments were actually negative.
12. Because a major financing package ($8.4 billion) for it is snagged in Congress, the IMF now finds itself on the brink of an emergency. In fact, its loan commitments already exceed the borrowed resources in its coffers, so that without an emergency loan (which it is now trying to obtain from Saudi Arabia and the Group of Ten [G-10] countries), the Fund may not be able to continue disbursing the money called for by present lending programs.
13. T. Killick, *IMF Stabilisation Programmes in the Third World.*
14. Williamson, *Lending Policies*, p. 20.
15. M.S. Khan and M.D. Knight, *Determinants of the Current Account Imbalances of Non-oil Developing Countries in the 1970s: An Empirical Analysis.*
16. Williamson, *Lending Policies*, p. 14.
17. Budgetary restraint arguments do not appear to hold much ground in the debate over multilateral agencies' funding. Indeed, as a recent study showed, every dollar contributed to the multilateral development banks resulted in an increase of three dollars in the gross national product of the United States. See M.J. Seiber, *International Borrowing by Developing Countries*, p. 7.
18. On guarantee and insurance schemes, see Lal Jayawardena, "International Keynesianism: A Solution to the World Crisis?", pp. 149–74; and IMF/World Bank Development Committee, Task Force on Non-concessional Flows, *Non-concessional Flows to Developing Countries.*
19. F. Stewart and A. Sangupta, *International Financial Cooperation: A Framwork for Change*, p. 93.
20. M. Camps and C. Gwin, *Collective Management: The reform of global econonic organizations*, p. 265.
21. Recent World Bank estimates indicated that a doubling of aid in real terms, combined with policy reforms aimed at structural adjustment, could increase per capita incomes in oil-importing Africa by nearly one-quarter during the coming decade, compared with virtual stagnation without it.

6: *Conclusions*

The external debt of developing countries is an international economic problem that will challenge both developing and industrial countries alike in the 1980s. Indeed, lending to less-developed countries (LDCs) represents simultaneously a vehicle for further LDC growth, a lubricant to industrial country exports and growth, and a hostage that will make it increasingly difficult for the Northern countries to walk away from their Southern counterparts without jeopardizing their own financial stability.[1]

Moreover, the external indebtedness of the developing countries must be looked upon not as an isolated problem, but as a result of the profound changes in the world economy during the last decade. Its increase has largely been a consequence of factors beyond the control of debtor countries, factors which, by occasioning the appearance of structural surpluses in some countries, also gave rise to the emergence of structural deficits in others. These developments paved the way for the enlarged role of private banks as the main suppliers of balance-of-payments support, given the paucity of official sector financing.

Recognition that the LDC debt problem belongs to the international community as a whole, and not simply to debtor countries, has led us to a re-examination of the mechanisms for recycling and facilitating real resource transfers to the developing countries. Although it is generally wrong to ascribe to private bank recycling the major responsibility for the Third World's debt crisis—a crisis which banks are themselves locked into—it is clear that under current world economic conditions, and given the design of the

framework for financing and adjustment to global payments imbalances, a prolonged policy of accommodating balance-of-payments deficits through the provision of credits via market channels has considerable shortcomings.

As the privatization of the LDC debt structure embodies, to a large degree, the inappropriate use of short-term finance to deal with long-term (that is, structural) imbalances, the case for other financing mechanisms need hardly be stronger. In the absence of more decisive, international, financial support, continued failure on the part of creditor governments and agencies to seek ways in which to address the complex issues raised by the growth of LDC external indebtedness could lead to a further deceleration of overall growth in the world economy.

The events of the past few years have demonstrated the extent to which LDC growth prospects are ultimately governed by financial constraints. Therefore, since LDC needs for net capital inflows, that is, for incurring debt, remain very high, new ways must be found to channel funds to these countries. These ways must be more consistent with the overall debt-servicing capacity of developing countries, given the harsher world economic environment of the 1980s. They must also be consistent with the need of LDCs to undertake longer-term structural adjustment in such an environment.

Both the design and pursuit of the reform proposals discussed in this paper embody the implicit assumption that the developing world's external debt problem represents essentially a problem of illiquidity, that is, a temporary incapacity to service debt, given the protracted state of the world economy, as opposed to a more somber situation of generalized insolvency.[2] Equally clear, however, is the fact that a failure to engineer the changes required to deal with the present shortcomings in recycling arrangements is likely to create conditions whereby illiquidity may suddenly transform itself into global insolvency.[3] It remains to be seen, therefore, whether all actors involved will recognize their responsibilities for contributing to a more constructive world economy, and so reduce the share of the burden of world deflationary policies now falling on those least able to bear it.

Notes

1. W. R. Cline, *External Debt and Financial System Vulnerability*, pp. 1–9.
2. Insolvency could be defined as a situation where the size of non-oil LDC deficits is such that, given the overall world economic climate as

well as the state of disarray characteristic of world financial markets, their financing would prove simply impossible; the situation would trigger a series of defaults whose impact on the international economy could be calamitous.

3. See W. R. Cline, *Developing Country Debt under Alternative Global Conditions: 1983–86*, pp. 1–3.

Key to Acronyms

BIS — Bank for International Settlements

CFF — Compensatory Financing Facility (of IMF)

CMEA — Council for Mutual Economic Assistance

DAC — Development Assistance Committee (of OECD)

EEC — European Economic Council

GDP — gross domestic product

GNP — gross national product

IBRD — International Bank for Reconstruction and Development (World Bank)

IDA — International Development Association

IDS — Institute of Development Studies

IMF — International Monetary Fund

LDC — less-developed country

LIBOR — London Interbank Offered Rate

NIC — newly industrialized country

ODA — official development assistance

ODI — Overseas Development Institute

OECD — Organisation for Economic Co-operation and Development

OPEC — Organization of Petroleum Exporting Countries

PVD — Pays en voie de developpement

SAL — Structural Adjustment Loan

SDR — Special Drawing Rights (on IMF)

World Bank — International Bank for Reconstruction and Development (IBRD)

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